No. 22,400

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

CHARLES H. LUNDQUIST, *Appellant,*

vs.

JOE TURNER, *Appellee.*

Appeal From the United States District Court for the Central District of California.

REPLY BRIEF OF APPELLANT.

HURLEY & DRISCOLL,
By ROBERT W. DRISCOLL,
2540 Huntington Drive,
San Marino, Calif. 91108,
Attorneys for Appellant.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Statutes

Textbook

No. 22,400

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

CHARLES H. LUNDQUIST, *Appellant,*

vs.

JOE TURNER, *Appellee.*

Appeal From the United States District Court for the Central District of California.

REPLY BRIEF OF APPELLANT.

ARGUMENT.

In his "Appellee's Brief", Joe Turner says, at page 6,

> "But surely it cannot be contended that a transfer of $25,000.00 worth of debentures to Glen R. Roland would destroy the private offering exemption. Since any agreement by Mr. Turner to transfer some of his interest in the debenture to Mr. Roland would not destroy the private offering exemption, Mr. Turner's conduct would not invalidate the debentures. . . ."

This statement shows the failure of appellee Turner to grasp the issue in this case, which is, basically, can a buyer invoke the civil remedy under Rule 10b-5* to re-

---

*References to Rule 10b-5 are to the Rules promulgated by the Securities and Exchange Commission under the Securities and Exchange Act of 1934 and amendments thereto.

cover from another buyer? The statement by appellee also blithely assumes that a buyer in a private offering situation can parcel out his investment by pre-arrangement to third parties not included in the private offering, despite express representations and warranties that the buyer is buying the entire amount of his purchase for his own investment account. The cases hold that transactions exempt under the 1933 Act are subject to 10b-5.

Hooper v. Mountain State Securities Corp., 282 F. 2d 195, 201 (5th Cir. 1960), *cert. denied* 365 U.S. 814 (1961);

Fratt v. Robinson, 203 F. 2d 627 (9th Cir. 1953);

Rustic v. Werblin, CCH par. 91,637 (S.D. N.Y. Feb. 28, 1966);

Robinson v. Difford, 92 F. Supp. 145 (E.D. Pa. 1950);

Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

Appellee, unfortunately, cites no authority whatsoever for any of his generalizations contained in the "Introductory Analysis" of the brief, pages 4-7, inclusive. Rather, the bulk of his brief is devoted to attempting to distinguish or minimize the authorities cited by appellant in appellant's Opening Brief.

However, 5 new cases are cited by appellee which deserve attention, and it is the purpose of this Reply Brief to rebut the conclusions drawn by appellee from those 5 cases.

1. *Ross v. Licht,* 263 F. Supp. 395 (S.D. N.Y. 1967) at pp. 408-409, is cited by appellee on page 20 of

his brief to show that the identity of the purchaser is not a material fact, and that Lundquist did not care what Turner might do with his debenture, so long as Turner's conduct would not destroy the private offering exemption. In the *Ross* case, the plaintiffs were actually soliciting a sale to the insiders long before the transaction in question, and they were required to first offer their stock to the other shareholders, including the officers, directors and insiders. Thus, this case is a particularly inapt citation. In the instant case, the debenture purchasers expressly represented in Paragraph 10 of the December 1, 1960 Agreement, that they were purchasing for their own account, and expressly agreed not to sell or transfer their stock without first obtaining a permit from the Corporation Commissioner of California, and agreed that the issue was expressly dependent on these representations.

The only evidence offered on the question of the validity or invalidity of the issue of securities was that testimony of Graham Sterling, Jr., who qualified as an expert in securities law, and his testimony clearly favored appellant's contention that the secret sale by Turner to Roland and the pledge to the Oklahoma banks each constituted acts which violated the terms of the Commissioner's permit and rendered Turner liable for civil damages under 10b-5, and made Turner a statutory underwriter.

2. *List v. Fashion Park, Inc.,* 340 F. 2d 457 (2nd Cir., 1965) is cited by appellee at page 1 for the proposition that a reasonable man test is added to the subjective requirement that the individual plaintiff must have acted upon the fact misrepresented. Appellant has no quarrel with this proposition, nor with the rule enun-

ciated in the *List* case, but wishes to point out that the same case contains another quotation which is much more appropriate than the one used by appellee, namely, the language appearing on pages 461-462 which states:

> "lack of communication between defendant and plaintiff does not eliminate the possibility that Rule 10b-5 has been violated." (citing *Cochran v. Channing Corp.*, 211 F. Supp. 239, 243 (S.D. N.Y. 1962) and *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951), aff'd 235 F. 2d 369 (3 Cir. 1956).

3. *Rogen v. Slikon Corp.*, 361 F. 2d 260 (1st Cir. 1966) is cited by appellee on the issue of materiality. The case involved the "reluctant" reversal by the appellate court of a summary judgment granted by the District Court in defendant's favor. The misrepresentations there involved statements as to the business prospects of the corporation, and the plaintiffs signed a contract acknowledging full familiarity with the corporation's business and prospects, and acknowledged that the plaintiffs "are not relying on any representations or obligations to make full disclosure with respect thereto." (p. 265). Besides being factually distinguishable, and besides actually sustaining appellant's position here respecting disclosure rather than appellee Turner's position, the case is of questionable authority because of the contradictory language it uses emphasizing the closeness of the factual question. In the instant case, Turner made an express written representation to induce the stock sale, and admittedly had a secret deal with Roland which was not to be disclosed to U.S.C.M.'s Board of Directors because Turner and Roland didn't want the Board to know about it.

4. *Kohler v. Kohler Co.,* 319 F. 2d 624, 642 (7th Cir. 1963) which was erroneously cited by appellee as a Ninth Circuit decision, involved conflicting accounting testimony about the effect of treatment of pension costs and a tax refund. The plaintiff had attended a shareholder's meeting at which the accounting treatment had been discussed. The Court said, at page 641,

> "In appraising plaintiff's contentions, we think the duty of disclosure of material facts placed upon corporate insiders such as defendants by Section 78j(b) and Rule X-10B-5 is necessarily limited to an exercise of fair and honest business practices under all the circumstances existing at the time of the transaction."

Compare the conduct in the *Kohler* case to Turner's blatant disregard of his express written warranty, his secret and fraudulent dealings with Roland designed to keep the Board of U.S.C.M. from discovering Roland's participation, and Turner's multiple violations of the terms of the Corporation Commissioner's Permit, and one must conclude that Turner's conduct was the antithesis of "fair and honest business practices."

The 4 cases cited by appellee above all are cited to support appellee's position that Turner's misrepresentations and concealments were "immaterial" and that even if known by Lundquist would not have changed Lundquist's course of conduct in going through with the purchase of his $420,000 worth of debentures. This position of appellee is totally without support in the evidence. The only evidence on the point is Lundquist's testimony* that he would not have purchased

*Reporter's Transcript, p. 116, line 16, to p. 123, line 21.

the debentures had he known that the violations had occurred. The trial court refused to permit evidence on causation and damages which would have elucidated this testimony. Surely, the fact that the reputable law firm of O'Melveny & Myers based its legal opinion as to the validity of the issue on the express warranties and representations of the buyers, including Turner's statements contained in paragraph 10 of the December 1, 1960, Agreement, cannot be discounted.

Furthermore, appellee fails to distinguish between "materiality" in a 10b-5 case involving an open-market sale, and "materiality" in a private transaction. This distinction is clearly pointed out in the recent book by Alan R. Bromberg (McGraw-Hill Book Co., 1967), entitled "Securities Law—Fraud—SEC Rule 10b-5" where the author states, at page 199:

> "Materiality is one common-law element that is still going strong under 10b-5. It is required by the express language of clause 2 and by the interpretations of the others. If anything, materiality has achieved more prominence as the Rule is applied to subtler or milder cases. Thus, materiality needs to be more pronounced and more carefully measured in open-market transaction because of potential massive liability to hordes of investors who are in fact trading on a variety of data, appraisals, and intuitions. Some sort of reasonable-man, objective test of investment judgment, intrinsic value, or (in the case of a publicly traded security) significant market effect is appropriate. Such tests have been formulated in a variety of different phrases. (citing in the footnote *Rogen v. Ilikon Corp.*, supra, and *List v. Fashion Park, Inc.*, supra,

cited by appellee Turner). A looser test may be more suitable for affirmative misrepresentations or deliberately deceptive conduct. A looser or more subjective one may also be proper in direct-personal transactions because of the greater ability of one party to appreciate the position of the other. The latter proposition has found some judicial acceptance. In an open-market case, information had to be rather fully deveeloped before it became material, while in a direct-personal one, very tentative information was material."

See also *Janigan v. Taylor*, 212 F. Supp. 794 (D. Mass. 1962), 230 F. Supp. 858 (D. Mass. 1964) (on damages), affirmed 344 F. 2d 781 (1st Cir. 1965), cert. denied 382 U.S. 879 (1965), where the District Court found the undisclosed facts material by reason of the training and experience of the defendant, who must have known the facts to be material to the plaintiff's decision to go through with the transaction. In the instant case, Turner, with substantial business holdings in several States, signed the documents containing express representations which contradicted his own oral and written pre-arrangements with Roland and with the Oklahoma banks, and expressly stipulated that he understood the other parties to the transaction were relying on his representations.

5. The final case cited by appellee which requires analysis is *Kent v. Kent*, 6 Cal. App. 2d 488 at 492-493, cited at page 23 of appellee's brief. This case holds that where some shares are issued in violation of terms of a permit granted by the California Corporation Commissioner, this does not invalidate the remaining shares.

Once again, we are confronted with appellee's failure to grasp the issues involved in this case.

California is a "permit" state, that is, its Blue-Sky laws require that before securities can be validly issued, a proper permit must be obtained from the Commissioner. Permittted securities are thus valid, while those issued without a permit are void.

Corporations Code, Section 26100.

The Federal Securities Act of 1933 is a "disclosure" statute, requiring all securities to be preceded by a registration statement disclosing certain facts regarding the issue. There are certain exemptions from this disclosure requirement, however, including the "intrastate" exemption and the "private offering" exemption, where it is not necessary to file a registration statement with the S.E.C. in connection with certain transactions which fall within the exemptions. However, if the issue does not qualify for the exemption, then the exemption is unavailable, and the security must thus be preceded by a registration statement or it is void as to the whole issue.

Appellee fails to consider this basic difference between the two types of statutes, and thus incorrectly cites the *Kent* case, which is completely irrelevant and inapplicable.

That the pledge by Turner violated the terms of the California Commissioner's permit is apparently admitted by appellee (see Appellee's Brief, pp. 23-24), but appellee asks: What has this to do with appellant Lundquist or with *his* debenture? The answer is, the unrebutted testimony of Graham Sterling, Jr., was that the pledge violated not only the *Guild Films* doctrine, but

the terms of the permit, thus rendering the representations of Turner in the December 1, 1960 Agreement false, making Turner a statutory underwriter, and giving Lundquist a civil remedy under Rule 10b-5, which makes it unlawful for any person

> "(a) to employ any device, scheme, or artifice to defraud,
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security."

Conclusion.

Appellee Turner secretly conspired with Roland to sell off part of the debenture issue which Turner represented in writing to the other buyers that he was buying for himself alone, for investment and not for resale. Turner further violated the terms of the permit of the California Corporation Commissioner prohibiting a transfer without a further permit, both by his sale to Roland and his pledge to the Oklahoma banks. His conduct thus fell within the ambit of the language of Rule 10b-5, and a civil remedy is afforded to any person who is affected thereby in a securities transaction. Appellant Lundquist was effected, having bought and paid for $420,000 worth of the same debenture issue in reliance upon the truth of Turner's express repre-

sentations. The District Court, which seemed to be seeking some kind of privity before the Court could bring itself to accept the possibility of liability (although "privity" has all but disappeared from 10b-5 proceedings, according to Bromberg's book on Securities Law, page 205), erred in preventing Lundquist from proceeding on to the issues of causation and damages, and the District Court prematurely terminated the proceedings by making an incorrect determination on the issue of liability based upon an incorrect view of the law. For these reasons, the judgment of the District Court should be reversed, and the cause remanded with instructions that the District Court try the issues of causation and damages, and find in favor of appellant Lundquist on the issue of liability.

Respectfully submitted,

HURLEY & DRISCOLL,
By ROBERT W. DRISCOLL,
Attorneys for Appellant.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

ROBERT W. DRISCOLL